Clean-Up in Aisle 5: Does Bankruptcy Still Work for Retail?

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OUTLINE

1. **Lender avoidance strategies regarding the Code's landlord protections:**

   a. **Has there been anything clever done about the 210-day limit by which each nonresidential real property lease must be assumed or rejected? § 365(d)(4).**

      i. *In re Filene's Basement, LLC*, 2014 Bankr. LEXIS 2000 (Bankr. D. Del. 2014) – act of filing a motion to assume a lease within the relevant statutory period is sufficient to prevent deemed rejection of lease. As the debtor can always retract the previously filed motion, this effectively extends the amount of time a debtor has to decide whether to assume/reject a nonresidential real property lease by the amount of time it takes the court to issue an order regarding the motion to assume. Query whether this satisfies the statute?

      ii. *In re Eastman Kodak Co.*, 495 B.R. 618 (Bankr. S.D.N.Y. 2013)

         1. Facts:

            a. Kodak assumed a lease within the 210-day limit, and the order granting the assumption expressly preserved Kodak's rights to "assign any of the Assumed Leases pursuant to, and in accordance with, the requirements of section 365 of the Bankruptcy Code."

               i. Lessor ITT neither objected to the motion nor the court order approving it.

            b. A year later, Kodak filed a motion to assign the lease to another party as part of an asset sale agreement, to which ITT objected.

         2. Argument:

            a. ITT argued that a nonconsensual assignment must occur simultaneously with, not after, assumption of the lease – and thus cannot occur outside the 210-day period of § 365(d)(4).

            b. According to ITT, the use of the present tense of the verb "to assume" in § 365(f)(2), authorizing assignment only if "the trustee assumes such contract or lease" leads to the inference that assignment must take place at the time of the assumption.

         3. Holding:

            a. Kodak could assign the lease. The words of the statute do not require simultaneous assumption and assignment.

            b. 365(d)(4) does not contain a deadline to assign a contract.

            c. Interpretation of the Bankruptcy Code to permit the assignment of a previously assumed commercial lease outside the deadline for assumption reasonably balances the goal of providing protection to landlords and the goal of maximizing the value of a debtor's estate.

b. Courts can approve *nunc pro tunc* rejections so that landlords lose the benefit of administrative claims for rent between the nunc pro tunc date and the actual date of rejection.

i. *In re Sky Ventures, LLC*, 523 B.R. 163, 170 (Bankr. D. Minn. 2014) – "The objection by the Debtor to [lessor's] request for an administrative claim must be sustained. The Court's order of July 15, 2014 allowed the Debtor to reject the unexpired lease of nonresidential real property between it and [lessor], effective May 14, 2014, the petition date. The Court will not revisit the effective date of rejection. [Lessor] is not entitled to an administrative claim under section 503(b) for postpetition rents. Neither is it entitled to an administrative claim for any prepetition contract damages."

ii. *In re New Meatco Provisions, LLC*, 2014 Bankr. LEXIS 2377, at *12 (B.A.P. 9th Cir. 2014) – "[T]he Ninth Circuit held that the bankruptcy court may, in 'exceptional circumstances,' approve retroactively the rejection of an unexpired nonresidential lease. *In re At Home Corp.*, 392 F.3d 1064, 1071-72 (9th Cir. 2004) (bankruptcy court in exercising its equitable powers under section 105(a) may approve retroactive rejection of a nonresidential lease when 'necessary or appropriate to carry out the provisions of section 365(d)') (citing *In re O'Neil Theatres, Inc.*, 257 B.R. 806, 808 (Bankr. E.D. La. 2000)). It further held that the retroactive date may be earlier than the date on which the landlord retakes possession of the premises. *Id*. at 1065. This may include the date on which the debtor files the motion to reject. *Id*. at 1071-72."

2. <u>Stub rent / § 506(c) waiver in the Debtor-In-Possession Financing Order:</u>

a. Sports Authority Decision – The Delaware Bankruptcy Court would not approve a DIP lender's requirement that the estate waive its rights under 506(c) to charge the prepetition lender for protecting its collateral by paying stub rent (the unpaid rent for the part of the month before the debtor commenced its chapter 11 case)?

i. S*ee* Apr. 26, 2016 Hr'g Tr., Case No. 16-10527-MFW (Bankr. D. Del.) [ECF No. 1463], at 195:12-196:21.

1. The parties retained their right to argue they provided a benefit to a secured lender. *Id.* at 206:6-11.

ii. Section 506(c)

1. Although not addressing waiver, the Third Circuit reaffirmed that the applicability of § 506(c) is "sharply limited."

a. "Section 506(c) permits a claimant to recover expenses from the secured collateral only under "sharply limited" circumstances." *In re Towne, Inc.*, 536 F. App'x 265, 268 (3d Cir. 2013) (citing *In re Visual Indus., Inc.*, 57 F.3d 321, 325 (3d Cir. 1995)).

b. "[T]o recover expenses under § 506(c), a claimant must demonstrate that (1) the expenditures are reasonable and necessary to the preservation or disposal of the property and (2) the expenditures provide a *direct* benefit to the secured creditors." *Id.* (quoting *In re C.S. Assocs.*, 29 F.3d 903, 906 (3d Cir.1994)) (emphasis in original).

b. If full rent is due on the first of the month, and the debtor files the tenth of the month, is rent for the rest of the month a prepetition claim or an administrative expense?

i. In the Third, Sixth, and Eighth Circuits, the entire amount will be treated as a prepetition claim because the right to payment accrued in its entirety on the due date. *See In re Oreck Corp.*, 506 B.R. 500, 507 (Bankr. M.D. Tenn. 2014); *In re Koenig Sporting Goods, Inc.*, 203 F.3d 986 (6th Cir. 2000); *In re Montgomery Ward Holding Corp.*, 268 F.3d 205, 212 (3d Cir. 2001); *but see In re Leather Factory Inc.*, 475 B.R. 710 (Bankr. C.D. Cal. 2012) (prorating rent); *In re Circuit City Stores, Inc.*, 447 B.R. 475 (Bankr. E.D. Va. 2009) (same).

ii. What if the lease requires one rent payment per year, due on January 1 and the tenant files January 10?

1. In circuits that do not pro rate and while perhaps more inequitable or contentious, courts have recognized that this would not change the outcome above. *See Oreck*, 506 B.R. at 506 n.10 (acknowledging that any strategic behavior this causes "can be constrained by forethought and careful drafting") (quoting *Montgomery Ward*, 268 F.3d at 212).

a. One idea for careful drafting: the parties agree that rent is due on a daily basis, but if the tenant pays the entire month in advance, a discount is given. When calculated with the discount, the rent reflects the deal the parties would have entered if rent were due only once a month.

c. Can leases be sold free of a tenant's right of possession under section § 365(h)?

i. Precision Industries, Inc. v. Qualitech Steel SBQ, LLC (In re Qualitech Steel Corp.), 327 F.3d 537 (7th Cir. 2003)

1. **Facts.**

Precision had 2 prepetition agreements with the debtor, Qualitech. One agreement was a supply agreement under which Precision would construct a supply warehouse on Qualitech's property and operate it for 10 years while providing supply services. The other agreement was a 10-year land lease providing for rent of $1 per year. It provided Precision exclusive possession of the warehouse with a right to remove all improvements and fixtures on early termination of the lease. At the normal maturity of the lease, Qualitech had the right to purchase the warehouse and fixtures and other improvements for $1. The lease was not recorded. 327 F.3d at 540.

During Qualitech's chapter 11 case substantially all the estate assets were sold to the secured claimholders' for their credit bid of $180 million. Their outstanding mortgage claim was more than $263 million. The order approving the sale directed Qualitech to convey the assets "free and clear of all liens, claims, encumbrances, and interests…." 327 F.3d at 541. Precision had notice and did not object to the sale order. Id. Neither did it request adequate protection of its interest. 327 F.3d at 548. The sale order reserved for the purchaser the debtor's right to assume and assign executory contracts pursuant to 11 U.S.C. § 365. The sale closed before assumption of either agreement, but the parties extended the deadline for assumption on 4 occasions while negotiating. Ultimately, the lease and supply agreement were *de facto* rejected. 327 F.3d at 541

Although Precision padlocked its warehouse, New Qualitech hired a locksmith and took possession. Then, Precision filed an action with the District Court for wrongful eviction and other relief and New Qualitech asked that it be referred to the bankruptcy court, which it was. The bankruptcy court ruled the sale order provided New Qualitech the assets free of Precision's possessory rights. 327 F.3d at 541-542. But, the District Court reversed holding 11 U.S.C. § 365(h) prevails over 11 U.S.C. § 363(f). 327 F.3d at 542. Neither party asserted the requirements of section 363(f) were unsatisfied. 327 F.3d at 546.

ii. Holding

"With these points in mind, it is apparent that the two statutory provisions can be construed in a way that does not disable section 363(f) vis a vis leasehold interests. Where estate property under lease is to be sold, section 363 permits the sale to occur free and clear of a lessee's possessory interest – provided that the lessee (upon request) is granted adequate protection for its interest. Where the property is not sold, and the debtor remains in possession thereof but chooses to reject the lease, section 365(h) comes into play and the lessee retains the right to possess the property. So understood, both provisions may be given full effect without coming into conflict with one another and without disregarding the rights of lessees." 327 F.3d at 548.

iii. Rationale

The appellate court first observed neither section 363(f) nor section 365(h) limits the other by their terms. Second, section 365(h), by its terms, has a limited scope insofar as it pertains to rights arising on rejection of leases. Third, section 363 provides a mechanism to protect parties whose interests may be adversely affected by the sale of estate property. Namely, section 363(e) directs the bankruptcy court, on request, to prohibit or condition the sale as necessary to provide adequate protection. 327 F.3d at 547. In turn, adequate protection does not guarantee continued possession, but does demand "the lessee be compensated for the value of its leasehold – typically from the proceeds of the sale." 327 F.3d at 548. The Seventh Circuit reasoned adequate protection will "protect the rights of parties whose interests may be adversely affected by the sale of estate property." 327 F.3d at 547.

Sections 363(l) and 365(h)(1)(A)(ii) do limit section 363(f) by their terms and adequate protection protects the value of the lease when the lease rent is less than market rent, but does not protect the lessee's investments in the location such as marketing expense, employee training, nearby distribution centers, and the like.

iv. Precision Industries Is Right for the Wrong Reasons: Section 365(h) Does Not Elevate a Lessee's Possessory Right Above a Prior Mortgagee's Undersecured Lien; But Sections 363(f), 363(l), and 365(h), Can Not Correctly be Interpreted to Empower a Court to Divest a Lessee of Its Possessory Rights under Section 365(h)

1. The Lease's Susceptibility to Extinguishment in a Mortgage Foreclosure Is Dispositive

Outside bankruptcy, absent a nondisturbance agreement, a lease (including its possessory rights) can be extinguished by foreclosure of a prior undersecured mortgage lien. Nothing in 11 U.S.C. § 365(h) grants lessees rights to stymie senior mortgages. Indeed, the bankruptcy jurisprudence has recognized for a long time that the lessee's rights can be extinguished in bankruptcy by prior undersecured mortgage liens. In re Hotel Governor Clinton, 96 F.2d 50 (2d Cir.), *cert. denied*, 305 U.S. 613 (1938). Any congressional

effort to subordinate senior mortgage liens to lessee rights would have created quite a furor in commercial finance.

Therefore, Precision Industries could and should have been decided, consistent with Hotel Governor Clinton, on the simple and narrow ground that the lease was subject to extinguishment in foreclosure because it was subordinate to a mortgage lien of over $263 million secured by property worth no more than $180 million. The lease was not even recorded.

The problem with Precision Industries is its holding rested instead on an exercise in statutory interpretation concluding broadly (and unhinged to whether the lease is susceptible to extinguishment in a foreclosure) that possessory rights preserved by 11 U.S.C. § 365(h) can be extinguished by a sale of the property under 11 U.S.C. § 363(f) as long as the lessee's rights are provided adequate protection under 11 U.S.C. § 363(e). Accordingly, the correctness of that statutory interpretation is the issue.

v. Does any circuit other than the 7th circuit (*Precision Industries*) allow that?

1. No other appellate court has addressed the issue.
2. However, lower courts in other circuits have held that possession rights survive § 363 sales. *See In re Haskell L.P.*, 321 B.R. 1 (Bankr. D. Mass. 2005) (tenant's right to possess survived § 363 sale); *In re Zota Petroleums, LLC*, 482 B.R. 154 (Bankr. E.D. Va. 2012) (same).

3. Standard for Stay Pending Appeal of Section 365(h) Issue– *In re Revel AC, Inc.*, 802 F.3d 558 (3d Cir. 2015) (2 to 1)

i. Facts

The buyer purchased for $90 million from a chapter 11 estate, a casino costing $2.4 billion to construct. 802 F.3d at 561, 563-564. The bankruptcy court issued an order under Bankruptcy Code section 363(f)(4) approving the sale free and clear of a tenant's possessory rights under Bankruptcy Code section 365(h). The court ruled bona fide dispute requirement under section 365(f)(4) was satisfied because the debtor disputed the tenant held a true lease on the ground all rent was determined as a percentage of revenue. 802 F.3d at 563-564. The Third Circuit quoted a striking portion of the bankruptcy court's rationale providing the court "can't look at the result totally as to what the law requires," though if time weren't of the essence, it "probably would have put [the hearing] off to have more evidence presented." 802 F.3d at 564.

The bankruptcy court and district court denied the tenant's request for a stay pending appeal, which request pointed out the tenant's appeal could become moot under Bankruptcy Code section 363(m) without a stay. 802 F.3d at 564-565.

The tenant appealed to the Third Circuit the stay denial.

ii. *Issues*

Does the U.S. Court of Appeals have subject matter jurisdiction over the stay denial?

Should a stay be granted?

What are the standards for granting a stay?

iii. *Holdings*

Yes.

The portion of the sale order allowing the sale free of the lease should be stayed. 802 F.3d at 575.

The Third Circuit ruled the four factors determining whether a stay should be granted should be balanced as follows:

> "To sum up, all four stay factors are interconnected, and thus the analysis should proceed as follows. Did the applicant make a sufficient showing that (a) it can win on the merits (significantly better than negligible but not greater than 50%) *and* (b) will suffer irreparable harm absent a stay? If it has, we "balance the relative harms considering all four factors using a 'sliding scale' approach. However, if the movant does not make the requisite showings on either of these [first] two factors, the [] inquiry into the balance of harms [and the public interest] is unnecessary, and the stay should be denied without further analysis." *In re Forty-Eight Insulations, 115 F.3d at 1300-01* (internal citation omitted). But depending on how strong a case the stay movant has on the merits, a stay is permissible even if the balance of harms and public interest weigh against holding a ruling in abeyance pending appeal."

Revel at 571.

iv. Rationale

The stay denial was final because the appeal would otherwise be moot:

> *"…Subsection 158(d)(1)* provides that "[t]he courts of appeals shall have jurisdiction of appeals from all final decisions, judgments, orders, and decrees" entered under subsections *158(a)* and *(b)*. Though a stay denial is not technically a final judgment, it is here in a practical sense because, under *11 U.S.C. § 363(m)*, the upshot of declining IDEA's stay request is to prevent it from obtaining a full airing of its issues on appeal and a decision on the merits, as that provision protects purchasers from any modification on appeal of an order authorizing a sale. Consequently, the District Court's decision denying IDEA's stay request was final for purposes of *§ 158(d)(1). See In re Trans World Airlines, Inc., 18 F.3d 208, 215 (3d Cir. 1994)* (acknowledging that "finality must be viewed more pragmatically in bankruptcy appeals under *§ 158(d)* than in other contexts"); *see also* James M. Grippando, *Circuit Court Review of Orders on Stays Pending Bankruptcy Appeals to U.S. District Courts or Appellate Panels, 62 Am. Bankr. L.J. 353, 360 (1988)* (arguing that "'finality' for purposes of *section 158* is a fluid concept to be determined [on] a case by case basis")."

802 F.3d at 566-567.

v. Public policy favors both the correct application of the Bankruptcy Code and the retention of jobs. 802 F.3d at 573. On the merits, there was no authority cited showing a percentage rent clause disqualifies a purported lease from being one. 802 F.3d at 574. That the tenant would prevail in its appeal was all but assured. 802 F.3d at 575.

4. Devan v. Simon Debartolo Group, 180 F.3d 149 (4th Cir. 1999).

a. Facts.

Merry-Go-Round, as chapter 11 debtor in possession, entered into a new lease. When the case proved unsuccessful, a going out of business sale was held during the chapter 11, and then the case converted to chapter 7. After unsuccessfully trying to sell the lease, the chapter 7 trustee returned the keys to the landlord and an order was entered deeming the lease rejected. The bankruptcy court granted the landlord a chapter 11 administrative claim for unpaid rent (subject to mitigation under state law), and the district court affirmed.

b. Holding.

The landlord has an allowable chapter 11 damage claim for breach of the postpetition lease. But, "[w]hether or not the future rent of a particular lease in a particular case is entitled to administrative priority is to be determined on a case-by-case basis just like any other administrative claim." 180 F.3d at 156. The test is whether the claim arises out of a postpetition transaction and was a necessary cost of preserving the estate. Here, it was entered into postpetition. The chapter 7 trustee's argument that it was of no benefit to the estate after conversion does not negate its being a necessary cost of preserving the estate because creditors can not be induced to enter into transactions with debtors in possession if they lose valid claims once the deal turns sour for the estate.

c. Dangerous Dictum about Rejection

The chapter 7 trustee argued that the lease was rejected. The appellate courts and the bankruptcy court ruled rejection only applies to leases entered into by the debtor, and not by the debtor in possession. The reason this issue is troubling is its implied significance. Rejection is actually nothing but a material breach. Bankruptcy Code section 365(g). The implication of the discussion, however, is that rejection would somehow make the lease go away, and the damage claim along with it. There is, however, no such thing as a rejection avoiding power.

d. Impact of Bankruptcy Code section 503(b)(7) (2005)

The 2005 amendments to the Bankruptcy Code addressed the consequences of rejecting an assumed nonresidential lease.[1] It limits the landlord's allowed administrative claim to two years'

[1] Bankruptcy Code section 503(b)(7) provides:

> **"(b)** After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including—
>
> **(7)**
>
> with respect to a nonresidential real property lease previously assumed under section 365, and subsequently rejected, a sum equal to all monetary obligations due, excluding those arising from or relating to a failure to operate or a penalty provision, for the period of 2 years following the later of the rejection date or the date of actual turnover of the premises, without reduction or setoff for any reason whatsoever except for sums actually received or to be received from an entity other than the debtor, and the claim for

rent, and is ambiguous as to whether the damages are mitigated by the space's rental value, as opposed to the actual entry into a new lease. Significantly, because the new section applies to the rejection of assumed leases, it does not squarely address the issue of rejection of a new lease.

5. <u>Miscellaneous retail bankruptcy issues:</u>

a. To use the bankruptcy process to liquidate collateral, lenders are often asked to "pay to play," meaning they must ensure administrative expense claims will be paid in full in the case. Is there anything interesting to say about this concept?

i. Many section 363 sales produce sales proceeds less than the amount owed to secured creditors. Such sales create an administrative insolvency where secured creditors are the only beneficiaries from the sale. Many courts have required the secured creditor to pay administrative claims associated with the chapter 11 case to obtain the benefit of the chapter 11 process and protections. This has been euphemistically referred to as the "pay to play" rule.

ii. In addition, creditors often assert that the chapter 11 process contemplates a benefit to all creditor classes and thus unsecured claimholders should receive a "carve-out" of the sale proceeds.

iii. Over the past several years, secured lenders have asserted that they have no obligation to fund 503(b)(9) claims because there is a material difference between such claims and the kind of postpetition operating expenses that facilitate a section 363 sale – unlike all of the other subsections of section 503, subsection (b)(9) applies to prepetition debt.

1. 503(b)(9) claimants have argued that it is inappropriate to discriminate between them and other administrative expense claimants and to do so is unjustified by the language of the Bankruptcy Code.

b. Current state of the law on whether real estate taxes due postpetition, but for a period commenced prepetition are administrative claims or prepetition claims?

<u>Relevant Statutory Language</u>

i. Bankruptcy Code section 503(b)(1)(B)(i) – "After notice and a hearing, there shall be allowed, administrative expenses, other than claims allowed under section 502(f) of this title, including . . . any tax incurred by the estate whether secured or unsecured, including property taxes for which liability is in rem, in personam, or both, except a tax of a kind specified in section 507(a)(8) of this title."

ii. Bankruptcy Code section 507(a)(8)(B) – "The following expenses and claims have priority in the following order: . . . Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for . . . a property tax ***incurred*** before the commencement of the case and last payable without penalty after one year before the date of the filing of the petition."

1. The 2005 BAPCPA inserted the word "incurred" above in the place of "assessed."

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remaining sums due for the balance of the term of the lease shall be a claim under section 502(b)(6);"

iii. Bankruptcy Code section 502(i) – "A claim that does not arise until after the commencement of the case for a tax entitled to priority under section 507(a)(8) of this title shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition."

Jurisprudence

iv. If a property tax claim is asserted after the petition date for a time period encompassing both pre- and postpetition periods, it is necessary to apply the test set forth in section 507(a)(8)(B) to determine whether and how much of the claim should be a prepetition claim.

v. Prior to the 2005 BAPCPA, courts employed different methods to determine whether a tax was a pre- or postpetition claim. Some courts used a proration method based on the number of days prior to the petition date. *See, e.g., In re 7003 Bissonnet, Inc.*, 143 B.R. 455 (Bankr. S.D. Tex. 1992). Other courts based their decision on the date economic liability arose under state law. *See, e.g., In re Members Warehouse, Inc.*, 991 F.2d 116 (4th Cir. 1993). Still other courts determined priority based on the date of assessment under state law. *See, e.g., In re Fairchild Aircraft Corp.*, 124 B.R. 488 (Bankr. W.D. Tex. 1991).

vi. Since the 2005 BAPCPA adjustment to Bankruptcy Code section 507(a)(8)(B) noted above, the operative test has been whether the property tax was "incurred" pre- or postpetition.

vii. There is very little jurisprudence on this issue in the past five years, but a couple cases have made it clear that when the tax in question is a state tax (such as property taxes), state law will determine when the tax is incurred. *See In re Northern New Eng. Tel. Operations LLC*, 504 B.R. 372, 379 (Bankr. S.D.N.Y. 2014) ("State law determines when a state tax is incurred."); *In re Donahue*, 520 B.R. 782, 786 (Bankr. W.D. Mo. 2014) ("I agree that the determination of when a state tax is 'incurred' is governed by state law.").

viii. State law will determine whether the property tax was incurred pre- or postpetition. Variations in state law will often lead to different results on similar facts.

1. In Georgia, "the owner of real and personal property as of January 1st [in any calendar year] is the person that incurs liability for the ad valorem taxes associated with that property." *In re Anchor Glass Container Corp.*, 375 B.R. 683, 685 (Bankr. M.D. Fla. 2007).

2. In New York, "liability [is imposed] for the property taxes on the tax status date." *City of White Plains v. A&S Galleria Real Estate, Inc. (In re Federated Dep't Stores, Inc.)*, 270 F.3d 994, 1001 (6th Cir. 2001).